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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

No. 530

ROBERT PAGE WRIGHT, BANKRUPT, *Petitioner*

vs.

VINTON BRANCH OF THE MOUNTAIN TRUST BANK OF ROANOKE, VIRGINIA AND A. C. HARRIS, *Trustee*

BRIEF IN RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States

1

Statement of Matter Involved

The sole question presented by the debtor's petition for a writ of certiorari to the United States Circuit Court of Appeals for the Fourth Circuit is the constitutionality of the Frazier-Lemke Act, which is Subsection (s) of Section 75 of the National Bankruptcy Act, as amended by the Act of Congress on August 28, 1935. (49 Stat. 942; 11 U. S. C. A. 203 [s]). As the record will disclose, the Circuit Court of Appeals of the United States for the Fourth Circuit, by a unanimous decision, declared this Act unconstitutional, their opinion being set forth in full in the record in this case.

Attention is likewise called to the record in this suit for the indebtedness of the petitioner as compared to his assets as shown by the schedule on pp. 4 and 5 of the record, the total value of his assets being $2,882.50 as compared to a total indebtedness of $6,559.50. The principal amount of the secured claims of $5,797.80 shown in Schedule A constitutes the debt the petitioner owes to respondent in this suit.

2

Rights of a Deed of Trust Creditor under the Virginia Statute

By the Statutes of Virginia (Acts of the General Assembly of Virginia of 1926, 324, p. 591, *et seq.*, entitled "An Act to amend and re-enact Section 5167 of the Code of Virginia, relating to deeds of trust," and approved March 24, 1926) it is among other things provided:

> "Every deed of trust to secure debts or indemnify sureties, except so far as may be therein otherwise provided, shall be construed to impose and confer upon the parties thereto, and the beneficiaries thereunder, the following duties, rights and obligations, in like manner as if the same were expressly provided for by such deed of trust, namely:
> * * *
>
> "(6th) In the event of default in the payment of the debt secured, or any part thereof, at maturity, or in the payment of interest when due, or of the breach of any of the covenants entered into or imposed upon the grantor, then at the request of any beneficiary the trustee shall forthwith declare all the debts and obligations secured by the deed of trust at once due and payable, shall take possession of the property and proceed to sell the same at auction at the premises (or at such other place as the trustee may select) upon such terms and conditions as the trustee may deem best, after first advertising the time, place and terms of sale in such manner as the deed may provide, or, if none be provided, then in such reasonable manner as the trustee may elect, no notice to the grantor or his successor in title being required."

These and cognate provisions are contained in Section 5167 of the Code of Virginia. They embody enlargements of the

State's deed of trust statutes that have existed for scores of years, and so generally have they been followed in practice that a mortgage is a rarity in Virginia. When a sale is made by the trustee—a third person—it is absolute, and no confirmation by any court is required, and there is no right of redemption.

In the opinion "In re Sherman, 12 Fed. Supp. 297, the learned Judge of the District Court for the Western District of Virginia said of the Virginia Statute in considering the constitutionality of the Frazier-Lemke Act here under consideration:

> "We may assume that the provision of the new Frazier-Lemke Act compelling an ultimate public sale of the property upon request of any secured creditor protects certain of the rights which were taken away by the old act; namely, the first, second, and fourth of the rights set out in the opinion in the Radford Case. But even if this be true, it seems clear that the amended act, equally with the original, threatens those rights which the Supreme Court enumerated as 3 and 5. These are in substance the right to determine when a sale shall be held and the right to control the property during default, pending the sale. In the Radford Case it was said that the creditor possessed these rights under the Kentucky law, subject only to the discretion of the court. In Virginia, the same rights exist in more absolute form, for their exercise is not subject to the discretion of any court, unless, it may be, they were exercised in such an oppressive or wasteful manner as to constitute a fraud upon the rights of the debtor and thereby call for restraint by the court in an independent suit instituted for that purpose.
>
> It will be noticed that in Virginia the trustee takes possession of the property following default, and thereafter sells the property at such time and place and upon such terms and conditions as he sees fit. It seems clear that the right to determine when a sale shall be held and the right to control the property pending a sale are abrogated by the Frazier-Lemke Act, even since its amendment. That act specifically provides that possession of the property shall remain in the debtor, and that all proceedings shall be stayed for a period of three years. That these provisions are subject to compliance with conditions imposed by the court does not lessen the fact that they take away rights previously vested in the creditor.

> The most that can be said is that the amended act preserves the right to retain the lien until the debt is paid, and to that end provides for a public sale at which the creditor himself may bid, and by bidding may, if necessity arises, take over the property itself. But the right to compel such a sale is delayed for a period of three years or until such time within that period as the debtor may determine by offering to pay the appraised value of the property. The property remains in possession of the debtor subject only to such supervision as to its handling as a court may be able to give and subject to the payment of a reasonable rental. During this period the value of the property may decrease while the indebtedness increases through accumulated interest. The first installment of rent is not payable until the end of one year, so that for at least a year the creditor must sit by while his debt accumulates with no assurance that at the end of that time the debtor will be able to fulfill the obligations imposed upon him, or that he will not deliberately fail to do so."

The above opinion by the learned District Court so precisely penetrates to the heart of the consideration of the constitutionality of this Act that further precision in the definition of the matter involved would not seem to be necessary. It should, however, be pointed out that this court has from time to time very definitely settled the proposition that the title and modes of disposition of real property within the various states are not matters placed under the control of Federal authority. (United States *vs.* Fox, 94 U. S. 315)

And this Honorable Court, by its unanimous opinion, in Louisville Joint Stock Land Bank *vs.* Radford (295 U. S. 555; 55 Supreme Court 854; 79 L. Ed. 1593; 97 ALR 1106) explicitly held that the first Frazier-Lemke Amendment wrongfully took from the lien creditor five definite property rights recognized by the law of Kentucky; and among these five property rights, described as "substantive rights in specific property acquired by the Bank prior to the Act," were the following that the Virginia statute provides for deed of trust creditors, viz.:

> "(2) The right to determine when such sale shall be held, subject only to the discretion of the court," and

"(5) The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt."

In comparing the position of the creditor with regard to his rights given him by the law of the State of Virginia as compared to the modification thereof by the Act under consideration, it is quite evident that this Act would take from the creditor not only substantial rights, but would give the creditor an investment that no rational investor would voluntarily make.

As Judge Paul forcibly points out in his opinion cited above, these property rights of the creditor under the Kentucky law are subject to the discretion of the court, but in Virginia they are absolute in form, because they may be enjoyed and exercised without the intervention of the court—the Virginia statute expressly providing that in event of default of the debtor, then, at the request of any beneficiary, the trustee shall forthwith declare all the debts secured by the deed of trust at once due, and shall take possession of the property and proceed to sell the same, no notice to the grantor or his successors in title being required.

This court has in numerous cases held that the law of the state in which lands are located are controlling upon it in respect of the validity and effect of mortgages and the transfer of title to real estate, and the decisions of state courts have been followed by federal courts concerning these rights in bankruptcy proceedings even to the extent of rejecting the latter court's own directly contrary ruling. (Cox *vs.* Wallace, 219 Fed. 126; Babbitt *vs.* Read, 236; Remington on Bankruptcy, 4th Ed., p. 1405.)

The petitioner largely relies on the Blaisdell case (290 U. S. 398) and the Kavanaugh case (295 U. S. 56)—both of which were considered by this court in the Radford case (supra), and the act of Minnesota involved in the first-named case was upheld upon the ground that the Minnesota statute was a reasonable exercise of the police or reserve power of that state; and

the act of Arkansas in the second-named case being stricken down because of its being an unreasonable exercise of that state's police or reserve power.

The weakness of the citation in the Blaisdell case (supra) scarcely needs to be pressed beyond pointing out that this was state legislation in the exercise of its police power, which the states alone may exercise, and was in no sense an exercise of the bankruptcy power which the states do not have. It would most certainly be defective reasoning to say that Congress, under the bankruptcy clause, could pass the same legislation as a state may pass under such powers as emanate from the residuary powers of the states and as restricted by the contract clause in the Federal Constitution. Even in this situation, this case holds that such relief must be appropriate to the emergency and be based upon reasonable conditions. The danger of this analogy is brought to the forefront when it is remembered that economic conditions may enlarge the police powers of the state, and while it may be the occasion of the exercise of delegated powers to Congress, it cannot enlarge upon those powers. (Wilson *vs.* New, 243 U. S. 332.)

The Kavanaugh case (supra) holds in brief that legislation is unconstitutional which changes the remedies available for the enforcement of the mortgage, which changes are made in a spirit of repression or without moderation or reason. Mr. Justice Cardozo, in his opinion, points out that statutes cannot be passed making the remedy of the lienor a shadow and states that not even changes of remedy may be pressed so far as to cut down the security of a mortgage without moderation or reason. Finding the Arkansas statute involved in that case in conflict with the contract and due process clauses of the Federal Constitution, there is no principle enunciated in this case that could possibly support the Act under consideration.

The petitioner also quotes extensively from the decision of this Honorable Court in the case of Continental Illinois National Bank & Trust Company of Chicago *vs.* Chicago, Rock Island & Pacific Railway Company, *et als.* (294 U. S. 648), wherein was considered the constitutionality of Section 77 of

the Bankruptcy Act relating to the re-organization of railroads engaged in interstate commerce. In that case the railroad company filed a petition seeking a re-organization, and in aid of the jurisdiction of the court, the lienholders of certain securities were enjoined from selling such securities. That injunction was in aid of a proceeding then pending and to afford time for the preparation and confirmation of a plan of re-organization. Further provisions of the Act under which the proceeding was instituted require that the plan of re-organization shall not be finally approved by the Commission until it has been accepted in writing and such acceptance has been filed in the proceeding by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims or interests would be affected by the plan, and by or on behalf of stockholders of the debtor holding two-thirds of the stock of each class, etc. And this court in the Radford case considered and distinguished its opinion in the case of Continental Illinois N. B. & T. Co. against C. R. I. & P. Railway, and had the following to say of the provisions of the Frazier-Lemke Act then in question:

> "Nor do the provisions of the bankruptcy acts concerning compositions afford any analogy to the provisions of Sec. 7. So far as concerns the debtor, the composition is an agreement with the creditors in lieu of a distribution of the property in bankruptcy—an agreement which 'originates in a *voluntary acceptance by his creditors.*' (Citing cases) So far as concerns dissenting creditors, the composition is a method of adjusting among creditors rights in property in which all are interested. In ordering the adjustment, the bankruptcy court exercises a power similar to that long exercised by courts of law (citing cases), and of admiralty (citing cases). It is the same power which a court of equity exercises when it compels dissenting creditors, in effect, to submit to a plan of re-organization approved by it as beneficial and assented to by *the requisite majority of the creditors* (citing cases). In no case of composition is a secured claim affected except when the holder is a member of a class; and then only when the composition is desired by the requisite majority and is approved by the court. Never, so far as appears, has any composition affected a

secured claim held by a single creditor. Compositions are comparable *to the voluntary adjustment with the mortgagee* provided for in Sec. 3 of the Frazier-Lemke Amendment. They are *not analogous to the* so-called adjustment *compelled* by Sec. 7." (Italicised for emphasis.)

By Section 7 of the first Frazier-Lemke Act (held unconstitutional in the Radford case) if a secured creditor objects to the manner of payments and distribution of the debtor's property as provided by that Act, then after setting aside the debtor's exemptions as prescribed by state law, the court was required to stay all proceedings for a period of five years and during which five years the debtor shall retain possession of all or any part of his property, under the control of the court, provided he pays a reasonable rental annually for that part of the property of which he retains possession; the first payment of such rental to be paid within six months of the date of the order staying proceedings, such rental to be distributed among the secured and unsecured creditors, as their interests may appear, etc.

Under the present Frazier-Lemke Act (August 28, 1935), any farmer failing to obtain acceptance of a majority in number and amount of his creditors may, after having certain state exemptions set aside to him, have the referee enter an order "that the possession, under the supervision and control of the court, of any part or parcel or all of the remainder of the debtor's property, shall remain in the debtor, as herein provided for, subject to all existing mortgages, liens, pledges, or encumbrances, * * *, and "When the conditions set forth in this section have been complied with, the courts shall stay all judicial or official proceedings of any court, or under the direction of any official, against the debtor or any of his property, for a period of three years. During such three years the debtor shall be permitted to retain possession of all or any part of his property in the custody and under the supervision and control of the court, provided he pay a reasonable rental semi-annually for that part of the property of which he retains possession. The first payment of such rental shall be made

within one year of the date of the order staying proceedings, the amount and kind of rental to be the usual customary rental in the community where the property is located, based on the rental value, net income, and earning capacity of the property. Such rental should be paid into the court to be used, first, for payment of taxes and upkeep of the property, and the remainder to be distributed among the secured and unsecured creditors, and applied on their claims as their interest may appear."

The present statute, it will be seen, changes the period of the debtor's possession, on condition that he pays rental, from five years to three years, but under the present statute the debtor has one year in which to make his first rental payment, while under the former statute he was required to make his first rental payment in six months, and under the present statute the first rentals are applicable to the payment of taxes and upkeep of the property, while under the former statute the rental was distributable among the secured and unsecured creditors according to their interest. Under the Virginia statute quoted above the creditor had the right immediately upon default to have the trustee take possession and to the revenues therefrom thereafter from a solvent tenant; but under this new Act, the bankrupt debtor has the right to retain possession of the property for at least one year upon his unsecured promise to pay rental for that year, etc., for the period of three years—with the possibility of the whole of the rentals, if any, that he pays may have been consumed in paying his taxes and the upkeep of his property.

The petitioner urges that if Congress can, under the general bankruptcy act, or by the amendments embodied in Sections 74, 77 and 77B, take away a creditor's right to enforce the personal liability of the bankrupt, or destroy the right of a dissenting minority to enforce the security of the obligations of the composing debtor, then Congress may, in the interest of the debtor, also restrict or postpone the right of a deed of trust creditor to enforce his rights. This, too, was urged upon this Honorable Court in the Radford case, and there passed upon as follows:

"The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment. Under the bankruptcy power Congress may discharge the debtor's personal obligation, because, unlike the states, it is not prohibited from impairing the obligation of contracts. Compare Mitchell *vs.* Clark, 110 U. S. 633, 643, 28 L. Ed. 279, 282, 4 S. Ct. 170, 312. But the effect of the Act here complained of is not the *discharge of Radford's personal obligation.* It is the *taking of substantive rights in specific property* acquired by the Bank prior to the Act."

3

The present Frazier-Lemke Act, declared to be an emergency measure, may apply to one geographical section and not to another

This provision in the Act has been cited as a lifeline to keep this act from being unconstitutional inasmuch as it provides that if in the judgment of the court such an emergency ceases to exist in any locality, then the court in its discretion, may shorten the stay of proceedings provided for therein and proceed to liquidate the estate. An emergency is defined in Webster's dictionary as "a sudden or unexpected occurrence or combination of occurrences demanding prompt action." Under this section a Federal Court would clearly be called upon to examine the economic welfare of each locality and inquire into the financial well-being of a majority of the citizens therein to determine whether or not the Frazier-Lemke Act should be enforced. Suppose the Federal Court would render a decision on this point and that ruling would be appealed from it to a higher court? What form of evidence could be produced that would satisfy a higher court in determining whether or not this act should apply? Furthermore, the application of this act would depend upon opinions as to the well-being of each community from time to time and would most certainly lead to a great state of confusion that would utterly destroy the provision of the Constitution whereby Congress is authorized to pass uniform laws on the subject of bankruptcy. This, of course, would run counter to the well-known and accepted

proposition that uniformity of this kind means geographical uniformity.

4

Conclusion

Respondent respectfully submits that a study of the present act, and of the opinion of this Honorable Court in the Radford case, and of the first Frazier-Lemke Act, that was by that case held unconstitutional, will disclose a studied effort by the draftsmen of the present act to give an appearance of compliance with the Radford decision, while at the same time it takes away from the creditor the same substantive right in specific property that was illegally to be accomplished by the first Frazier-Lemke Act.

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